BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
LORAN AND DAISY FREEMAN)

Appearances:

For Appellants: Marvin E. Helon, Attorney at Law

For Respondent: F. Edward Caine, Senior Counsel

O P I N I O N

This appeal is made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax against Loran Freeman in the amount of $3,944.46 for the year 1951, against Daisy Freeman in the amount of $3,944.46 for the year 1951, and against Loran and Daisy Freeman in the amounts of $11,473.88, $15,785.78, $18,563.76 and $22,031.86 for the years 1952, 1953, 1954 and 1955, respectively.

Appellant Loran Freeman owned and managed a coin machine business in the Fresno area under the name Freeman Novelty Company. Freeman Novelty Company owned bingo pinball machines, claw machines, shuffle alleys, a few music machines and some miscellaneous amusement machines. The equipment was placed in some 100 locations and the proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between Freeman Novelty Company and the location owner.

The gross income reported in tax returns was the total of amounts retained from locations. Deductions were taken for depreciation, salaries and other business expenses. Respondent determined that Freeman Novelty Company was renting space in the locations where the machines were placed and that all the coins deposited in the machines constituted gross income to it. Respondent also disallowed all expenses pursuant to Section 17297 (17359 prior to June 6, 1455) of the Revenue and Taxation Code which reads:

> In computing taxable income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his

gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities.

Initially, Appellants contend that the notices of proposed assessment did not comply with Section 18584 of the Revenue and Taxation Code, which provides that "Each notice shall set forth the reasons for the proposed additional assessment and the computation thereof." On each notice appears a statement that "Adjustment is made in accordance with the provisions of Section 1'7297 of the California Revenue and Taxation Code." There also appears a detailed reconstruction of gross income, the amount of expenses disallowed, and a statement that "The total amount represented by coins deposited in machines is deemed to be gross income to you. Reimbursement for payouts has been computed at 60% of total in machines; i.e. balance after reimbursement for payouts is 40% of total." Without deciding whether a failure to comply with Section 18584 would void the notices, we believe that the notices sufficiently complied with that section.

Appellants also urge that Section 17297 is unconstitutional. Some of the constitutional objections raised by Appellants with respect to this section were disposed of in Hetzel v. Franchise Tax Board, 161 Cal. App. 2d 224[, 326 P.2d 611]. In any event, we adhere to our well established policy not to pass upon the constitutionality of a statute in an appeal involving unpaid assessments, since a finding of unconstitutionality could not be reviewed by the courts. (Appeal of C. B. Hall, Sr., Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197, 3 P-H State & Local Tax Serv. Cal. Par. 58145.)

The evidence indicates that the operating arrangements between Freeman Novelty Company and each locution owner were the same as those considered by us in Appeal of Hall (supra). Our conclusion in ball that the machine owner and each location owner were engaged in a joint venture in the operation of these machines is, accordingly, applicable here. As we held in that appeal, the gross intake of each machine was income to both participants and any payouts were joint expenses.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, 3 CCH Cal. Tax Cas. Par. 201-984, 2 P-H State & Local Tax Serv. Cal. Par. 13288, we held the ownership or possession of a pinball machine to be illegal under Penal Code Sections 330b, 330.1, and 330.5 if the machine was predominantly a game of chance or if cash was paid to players for unplayed free games, and we also held bingo pinball machines to be predominantly games of chance.

Four location owners who had bingo pinball machines from Freeman Novelty Company testified at the hearing on this appeal. Two stated that they paid cash to players of the bingo pinball

machines for unplayed free games, One stated that he did not pay cash to players for the unplayed free games but did provide them with cigarettes, cigars and other merchandise at the regular retail prices for unplayed free games. One location owner testified that he rnade no cash payouts for unplayed free games. At the time of the audit in 1956 these four individuals were interviewed by Respondent's auditor and they all stated at that time that they paid cash to players of the bingo pinball machines for unplayed free games. Respondent's auditor also interviewed a fifth location owner who was not present as a witness at the hearing on this appeal. The fifth location owner told Respondent's auditor that he did not pay cash to the players for unplayed free games.

There were introduced in evidence eight collection reports prepared and signed by employees of Freeman Novelty Company. One of these reports had the words"Pay Outs 42.00" written on the back. The other seven had the initials "ABC" written on the back followed by an amount such as "19.00" or "34.00." Several of the pinball machines used in the business were called "ABC" pinball machines,

Appellant testified at the hearing on this appeal and answered most questions but, on grounds of possible self-incrimination, declined to answer questions concerning whether the location owners claimed amounts for payouts from the proceeds of the machines at the time of collections and whether the agreements between Freeman Novelty Company and the location owners permitted the location owners to take expenses from the total proceeds of the machines prior to the equal division of the net proceeds.

A party's refusal to answer a question on the ground of possible self-incrimination can give rise to an inference that a truthful answer to the auestion would have supported the opposing party's factual contentions. (Fross v. Wotton, 3 Cal. 2d 384 [44 P.2d 350].) Based on the evidence and on the inferences to be drawn from Appellant's refusal to answer certain questions on grounds of possible self-incrimination, we find that it was the general practice to pay cash to players of the bingo pinball machines for unplayed free games. Accordingly, the bingo pinball machine phase of the Freeman Novelty Company's business was illegal both on the ground of ownership and possession of bingo pinball machines which were predominantly games of chance and on the ground that cash was paid to winning players for unplayed free games,

Freeman Novelty Company had about ten claw machines. They were operated as closed chute devices, that is, the player who succeeded in having the claw pick up a figurine and drop it down the chute could not open the chute to pick the figurine out. He would, or course, receive cash in redemption of the figurine

which the claw had deposited in the closed chute. The figurines were redeemed for 50¢ or $1 each. We have previously held the operation of a claw machine to be illegal. (Appeal of Peter Perinati, Cal. St. Bd. of Equal., April 6, 1961, 3 CCH Cal. Tax Cas. Par. 201-733, 3 P-H State & Local Tax Serv. Cal. Par. 58191; Appeal of Edward J. Seeman, Cal. St. Bd. of Equal., July 19, 1961, 3 CCH Cal. Tax Cas. Par. 201-825, 3 P-H State & Local Tax Serv. Cal. Par, 58208.) Inasmuch as there was illegal activity, Respondent was correct in applying Section 17297.

Freeman Novelty Company had equipment in from 75 to 100 locations at a time. It would appear that the equipment consisted mostly of bingo pinball machines with shuffle alleys second in number. Appellant testified that there were about ten claw machines. The employees of the Freeman Novelty Company did collecting and repairing as to all. types of equipment handled by the company. There was thus a substantial connection between the illegal operation of claw machines and bingo pinball machines and the legal operation of shuffle alleys, music machines and miscellaneous amusement machines and Respondent was correct in disallowing all the expenses of the business.

There were not complete records of amounts paid to winning players on the bingo pinball machines and claw machines. Respondent estimated such amounts as equal to 60 percent of the total proceeds deposited in the machines. Because the records did not break down the income by type of machine, Respondent computed the unrecorded payouts as if such payouts were made with respect to all types of equipment owned by Freeman Novelty Company.

At the hearing on this appeal Appellant and Respondent stipulated that of the recorded gross income of Freeman Novelty Company, 65 percent came from bingo pinball machines and claw machines and 35 percent came from other types of equipment.

Respondent's 60 percent payout estimate was based on statements made by the four location owners interviewed by Respondent's auditor in 1956 who stated that payouts were made. One location owner estimated payouts as equal to 50 percent of the proceeds of the bingo pinball machines, another location owner estimated 60 percent, and two others estimated 66 percent. At the hearing on this appeal the location owner who had given an estimate of 50 percent reaffirmed this estimate. Another location owner who had previously estimated 66 percent estimated 50 to 60 percent at the hearing on this appeal. The eight collection reports in evidence can be taken together to indicate a payout percentage in the neighborhood of 40 percent. As we also held in Hall, supra, Respondent's computation of gross income is presumptively correct. The 60 percent estimate appears reasonable under the circumstances and is sutained. This percentage should

be applied only with respect to the portion of the recorded gross income derived from bingo pinball machines and claw machines determined in accordance with the stipulation.

Appellants have raised a question as to whether the notices of proposed assessment for 1951 were timely. The notices were mailed more than four years and less than six years following the filing of the returns. The notices would be timely only pursuant to Section 18586.1 of the Revenue and Taxation Code which extends the normal four-year period to six years if the taxpayer omits from gross income an amount in excess of 25 percent of the gross income stated in the return. The omitted gross income computed in accordance with this opinion amounts to about 80 percent of the gross income stated in the return and the notices of proposed assessment for 1951 were therefore timely.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Kevenue and Taxation Code, that the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax against Loran Freeman in the amount of $3,944.46 for the year 1951, against Daisy Freeman in the amount of $3,944.46 for the year 1951, and against Loran and Daisy Freeman in the amounts of $11,473.88 $15,785.78, $18,563.76 and $22,031.86 for the years 1952, 1953, 1954 and 1955, respectively, be modified in that the gross income is to be recomputed in accordance with the opinion of the Board. In all other respects the action of the Franchise Tax Board is sutained.

Done at Sacramento, California, this 19th day of December, 1962, by the State Board of Equalization.

Geo, R. Reilly, Chairman

John W. Lynch, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST : Dixwell L. Pierce, Secretary